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Address by Director of Credit Institutions and Insurance Supervision Fiona Muldoon to the Irish Banking Federation National Conference 2012

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'Towards real leadership: restructuring the Irish mortgage book one loan at a time'

Introduction

Ladies and gentlemen, thank you for asking me to speak to you. I am conscious that I am your invited guest and so I will start by saying, that today I do not intend to speak of comfortable matters. I hope to provoke you a little, maybe even vex you. You see, your conference blurb that speaks of a 'sector that has been humbled' and 'a leadership challenged to think again' set me to thinking and, rather than yet another speech on PRISM, or risk mitigation plans or the Corporate Governance code, I thought I would instead try and speak a little bit to my perception of the conference theme: namely Irish banks' progress on re-storing confidence and re-building trust.

Since I have taken on the role of Banking Supervision at the Central Bank of Ireland, I do believe I look at the Irish banking industry through an outsider's

eyes. I have spent some 20 years in the insurance industry and most of the last decade abroad. So given all that, I find myself the Prudential Supervisor of the Irish Banks and Credit Unions in the worst world-wide economic and banking crisis in a hundred years. As the line from the Talking Heads song goes – 'my god, how did I get here?' It has been a fascinating experience.

The failures of Irish banking were obvious from a distance, and they are even more so in hindsight. Like everyone else, I find my vision nigh perfect in the rear view mirror. So, the over-concentration in mono-line property lending, the poor credit underwriting, the absence of allowance for tail event, the 'culture of cosy' at board level, the general group-think, the massive regulatory failure: it is a sorry list. But you will be happy to know, I am not here to tread all of that ground again today!

Rather today, I would like to concentrate on how we move forward. I intend to focus particularly on mortgage resolution. I deliberately do not want to re-tread ground on the sins of the past or engage in how/where blame lies. It is in that context I suppose, that the conference flyer first piqued my interest but more of that later.

First up – where are we now on mortgage resolution? Well, the Central Bank has made arrears a top priority. The effect of the rapid and significant increase in arrears and its long-term consequences for households, the banks and the wider economy generally are now obvious to see. The Central Bank took a strategic approach and we have worked alongside you in the industry and with our policy makers to drive reform. The absence of any cultural skill set or knowledge base

in Irish banking for the arrears problems presented has been evident in the dearth of sustainable solutions found to date. The result is a drag on the economy, new lending and the banks' own future profitability.

We have clearly set our expectations to you and to your boards:

- Set up and grow efficient collection shops;
- Work through arrears cases;
- Address unsustainable debt;
- Plan and manage capital outcomes.

All of course, easier said than done!

We are at a crucial point in the mortgage arrears resolution work efforts at this stage. We are now in the phase where pilots are completed and full rollout of resolution options has begun. It is for that reason that I have chosen to focus on mortgage lending today – although many of my comments are, I believe, as pertinent to the SME book as well.

The completion of our distressed credit review (or DCOR) at the start of the year identified serious operational shortcomings. There was a lack of experience in Irish banking in this area. Clearly, we were in unchartered territory and we found that the banks' teams were generally too small and were insufficiently resourced with the appropriately experienced people. We pushed on this with all the major institutions: asking for an increased skill set, a bigger shop, a better operational platform and earlier intervention on 'pre-arrears'. Old-fashioned credit collection techniques were largely absent. We found that challenge to

SFS was minor and peripheral. There was little understanding or agreement around affordability. We found that systems were clunky and difficult to operate. Management information was not in place – I am a big proponent of what gets measured gets done! However, I believe it is fair to say that progress (albeit from different starting points) has been steady in all institutions on these issues since (again though at individually better/worse speeds). But, overall, I believe capability will begin to grow from here on out.

Coming off that work, we split our own approach in 2012 into three broad areas:

- Protecting the consumer (CCMA)
- Work out products and strategies to address the problem: strategies that will work for the bank and for the borrower and that minimise the risk of contagion
- Building operations to deal with arrears customers

So how has that been working for us? Let us look at where we stand. As of June 2012 there is some €144bn in the banks in home loans across principal private residence and the buy-to-let sectors. Of that, some 167,000 loans are in arrears at a value of €35bn. A further €9bn or 51,000 loans have been restructured and are not in arrears but the vast majority of these restructures are in the 'treading water' space i.e. they are interest-only forbearance modifications that over a longer time frame do little to address the ultimate repayment capacity issues.

This diagram shows the boulder that must be pushed up the hill by the industry. It represents years of future hard work and patience until this long-term debt

mountain has been effectively dealt with. Further, it shows that if we do not effectively deal with the problem, extract value for the tax payer/shareholder from the loan assets, if we do not continue as a society to operate in a repayment culture then the bill becomes simply too big to carry. Meanwhile the misery of personal indebtedness, that is unsustainable for so many people, must be meaningfully dealt with. This is the size of the task and the enormous difficulty of it. This is the needle to thread over the coming years!

And, if this is what we all face then I also want to tell you what I have found since I came to Irish banking: my experience is not necessarily of an industry 'humbled'. I am not even sure what that means. Did I spend too long in a North American environment? I am not even interested in the notion. The Americans, of course, make their mistakes and clean them up quickly. They use them to learn and to 'move-on' as they like to say. In fact, in that culture business failure and picking yourself up thereafter is often viewed as a badge of honour – battle scars as it were. Success is about finding the solutions. Why the need to still talk of "being humbled" four years on? Does it strike anyone else as a bit 'sack cloth and ashes'? A little penitential? Is it that we still require our 'sinners' to go through "purgatory" and "atonement"? I am not sure. In any event, when I deal with the banks, I have not found humility. If the industry is grieving for the death of the economy, the mistakes of the past, I know which stage of grief it looks like to me!

The economic milk spilt in poor lending, the losses already incurred, have not even begun to be cleaned up. Moving to this chart: it shows that of the

168,000 PDH customers in arrears, half of them by value and by number have no formal arrangement in place.

My next chart breaks that down further and shows the extent to which ‘wait and see’ has become the strategy of choice. In that regard, my question four years in is what is it that we are waiting for on mortgage arrears? The hope for an economic recovery, hope that house prices will come back, hope that PIA will handle the issue for you? This is the stuff of denial. Hope is not a strategy – any more than anger. The path to viability will be through taking each loan, each customer and working out a solution that both responds to their needs and to a bank’s need to collect where it can. (In that regard I very much welcome the recent newspaper report that showed one institution setting out its stall on basic standard of living and affordability guidelines for distressed borrowers). This path will respond to the ability to pay and recognise the fundamental truth that what can’t be repaid won’t be repaid. It will also need to be tough minded enough to distinguish these unfortunate cases from those who think they would like ‘a slice of the action’.

Progress is even slower in the buy-to-let sector. And this is where the emotional issues surrounding the family home are not even in play.

Again, we can see that even where some progress has been made, the vast, vast majority of it is in the interest only space. With rental yields rising and a reasonably buoyant rental market, surely there is room for more creativity in this sector. Undoubtedly, the need to overcome the difficulties of the Dunne Judgement is a factor, but on its own, it cannot account for the lack of real

progress in this area. There are significant numbers of buy-to-let loans on Interest Only Tracker Rates in deep arrears - so what exactly is the commercial rationale for ‘wait and see?’ strategy on these cases. Further falls in assets values have just simply increased ultimate losses for both bank and borrower alike.

Viability of your sector, a return to profitability, a business model that prices correctly and is fully functional; these are good and worthy topics. But, the current balance sheet must be resolved too. The economic milk is spilt and as night follows day, there are poor loans of doubtful recoverability on the balance sheet – work out and resolution must follow. The approach to the mortgage arrears resolution strategy (MARS) project by the banks has generated some positive momentum but too often, it has been characterised by reluctance, a preference for the status quo or an adherence to the letter of the request rather than the spirit. My experience of MARS so far might be considered by anyone who parents or ever has parented a teenager. The Central Bank has led on the issues; the banks have waited to be told what to do and not particularly liked it when we have done just that. They have sometimes criticised us for getting it wrong; and sometimes we have. But, at least we cannot stand accused of inaction. The relationship between banking and the regulator has too often felt like a parent/child dialogue and you know what, this will not move banking out of its current difficulties.

The unsustainability of the situation for the banks is highlighted by stripping all the data back to two simple things. This chart shows annual percentage change in lending and deposits since 2004. We could argue long and hard about how

much of this is supply led or demand driven (on the lending side) but I think we can all agree it does not paint a picture of long-term viability.

Look, the banks must be cautious when it comes to work-out – the contagion risk in this area is significant. Unemployment is still rising, as are arrears. The situation is far from contained and the Personal Insolvency legislation is a game changer in many respects. So, I am not here to say that any of this is easy or to advocate a ready, fire, aim approach to economic co-participation on bad loans already made. I am definitely not here with all the answers to wave a magic wand and, in any event, I represent an unlikely fairy godmother! The risks are large and there must be a measured approach taken. But, there absolutely has to be an urgency of purpose. In order to be viable, the risk (of contagion) must be balanced by the absolute imperative to take action, slow measured and careful action granted; but action nonetheless.

So what I say today is forget about humility, and get busy fixing. What is needed now is authentic leadership not humility; some courage to act. No one is arguing for an overnight avalanche of available resolution options offered to thousands and thousands of borrowers. There just needs to be a proper beginning – step by measured step. Getting it wrong, learning, going back, correcting, moving again. This is what success will look like. It will be slow, modest and gradual. Starting now and resolutely sticking to it, this is what leadership will look like. It will not involve a 'ta-da' moment or a grand solution. Do not wait to be told by Government or by the regulator or Europe or the Troika, it is up to banking to rebuild its own relationship with its customers and

with society generally. This will be done by owning its problems and doing the hard work of clean up. This is how credibility will be regained:

The stakes are high. Stuck in stasis but at least hunting with the pack, I see too much 'activity' and not enough 'outcome'. I see too much lip service to 'progress' and 'meaningful resolution' and not enough to 'reality'. I see too much 'give the Central Bank exactly, literally, what they asked for' and not enough true dialogue and meaningful engagement to find a solution. I see way too many 'Extend and Pretends' masking as solutions!

And this is the most disappointing part. A culture of leadership is missing in Irish banking: many of you may dislike me for saying this but arguably, if it was also missing in the creation of the credit bubble then it is still missing. This is your chosen profession, you are the thought leaders, the senior managers and it is all of you who will determine the outcome for your own institutions and more broadly for the economy. Does it ever worry you how many new college graduates are looking at banking as a career now? Or, how young people feel about bankers when asked? How will banking attract its share of the brightest and most able of the next generation? Without some courage and some leadership in the mortgage resolution space, something that re-builds the social contract between the industry and wider society, something that re-gains and recaptures respect in an old and venerable profession, well, I am not sure it can. And, if you want to talk about future viability, prosperity and success, in a people business such as yours, attraction and retention of ethical, idealistic, bright, savvy, young people surely has to be mission-critical.

Am I being horribly unfair? What about all of your effort so far? What about all of the activity? The pilot projects? Can I not point to much solid progress? Of course, I can. But I am not here today to tell you how great you are, to say it is enough, or to let you off so easy. It is not my job to tell you what you want to hear. Rather I am here to say, yes a lot has been done but the hard stuff is only getting started and it is taking too long, and too much of it is driven by the regulator. This is in all our interests. Most of all it is in the industry's own interest too. This resolution work is undoubtedly not a job for the faint hearted. It is politically charged, it will be difficult, mis-steps will happen, there will be many carping from the side-lines and almost certainly the first commercial solutions and products will not look like the last. But, to just begin in a meaningful way would be huge and make no mistake, what it needs most is not humility (although clearly a measure of it is always nice!). Rather, what this task needs is courage and courage is the stuff of leadership.

The stakes are high. Absent a new fact pattern for PCAR models, the results for the banks' capital standing are pretty obvious. In addition, the State cannot afford for the cultural breakdown of repayment of legitimately borrowed debt. There can be no widespread assumption that links negative equity in borrowers' minds in any way to debt forgiveness. We simply cannot afford it. The level of capital required by the banks at next PCAR will be determined by a few key assumptions. It is conceptually a relatively simple thing to model. It is a model driven by a few key assumptions. House prices, unemployment and the cure rate. The only one of these in any way within a bank's control is the last. It is on that you will be judged, not just by the regulator (although we do intend to keep a very close eye!), but more importantly and due to the critical role of

banking in growing any modern economy, and given the desperate need for growth to fix our public finances and our unemployment rate, it is how you will be judged by history. Banking has failed once and Ireland is paying the price. We cannot 'move on' to new lending and new growth until the problems of the here and now are dealt with. To fail to find meaningful lasting work-out and resolution for the assets already on the balance sheet is to fail us all twice.

Banking leadership must find a way to work through its problems and not allow that to happen.

Thank you